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The Fix Is Out:

A Defense of the Floating Canadian Dollar

by

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The recent strength of the Canadian dollar has prompted proposals that Canada should adopt a fixed exchange rate against the U.S. dollar. Some proponents of this idea argue that a fixed exchange rate would help to insulate the Canadian economy from shocks arising in specific sectors. Others maintain that it would alleviate, or even make unnecessary, the pain of the Bank of Canada's current tight monetary policy.

Neither economic theory nor Canada's historical experience with fixed exchange rates supports these claims. The consequences of real shocks to the economy cannot be avoided by altering the exchange-rate regime: if such shocks are not allowed to move the nominal value of the Canadian dollar, they will produce changes in domestic prices and costs that have similar long-run consequences. And simply announcing a (potentially adjustable) pegged value for the Canadian dollar is in no sense a substitute for discipline in the conduct of monetary policy.

Instability in the foreign-exchange market reflects deeper economic uncertainties and policy failures. In particular, the recent high value of the dollar is the result of a shift away from the inflationary monetary policy of three years ago. More generally, erratic monetary policy, lax fiscal policy, and doubts about future responses to economic and constitutional challenges are among the root causes of fluctuations in the Canadian dollar. The attention of Canadians would more appropriately be given to dealing with these underlying problems than to a futile attempt to suppress their symptoms by tampering with the exchange-rate regime.

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Introduction

A prominent feature of the Canadian economic scene during the past two years has been the strength of the Canadian dollar in the foreign-exchange market. In January 1990, it traded above 86.5 U.S. cents, a value not seen since 1980; and during the first half of the year, its price has averaged about 85 U.S. cents, or 7 percent above the average of the previous ten years.

This strength has prompted renewed interest in adopting a fixed exchange rate against the U.S. dollar. Though such a course of action is not high on the political agenda at the moment, it is being advocated by some of Canada's most respected economists and thus deserves attention.[1] Proponents of a fixed exchange rate argue that it will bring one or more of the following benefits to Canada:

- it would reduce the impact of shocks arising in specific sectors of the economy on other sectors;
- it would eliminate the alleged tendency for the effects of tight monetary policy, as reflected in the high Canadian dollar, to be concentrated on the tradeables sector of the economy;
- it would help get Canadian inflation down to U.S. rates;
- it would help to eliminate — or at least significantly reduce — the premium of Canadian over U.S. interest rates;
- more generally, it would impose beneficial, long-run, anti-inflation discipline on Canadian monetary policy; and
- it would defuse speculation in the foreign-exchange market.

There are, however, reasons for skepticism about the capacity of a fixed exchange rate to deliver the benefits claimed for it. This *Commentary* sets out these reasons. First, it discusses what fixing the exchange rate would mean in practice. It then reviews the manner in which the Canadian economy might respond to various economic forces under fixed and floating exchange-rate regimes. Next, it examines each of the above-mentioned arguments for a fixed rate in light of that review, and goes on to discuss two critical issues upon which advocates of a fixed exchange rate must take a position — namely, the level, and the time, at which to peg.

We conclude that current pressures in the foreign-exchange market do not arise from the nature of the exchange-rate regime itself and that, therefore, the case for fixing the Canada-U.S. exchange rate rests on shaky ground. The exchange rate's instability has deeper, though not very mysterious, causes.

First and foremost, the fact that monetary policy moved from a loose stance in 1986–87 to a tight one in 1990 is undoubtedly responsible for much of the dollar's recent appreciation. Capital inflows associated with lax fiscal policy and changing patterns of international trade and investment also play a role here. And concerns about domestic political tensions are likely to add to the exchange rate's volatility in the medium-term future. All of these factors will continue to create instability for Canadian economic performance generally, and for the foreign-exchange market in particular, for as long as they persist — regardless of the nature of the exchange-rate regime.

What Does Fixing the Exchange Rate Mean?

Why Separate Currencies Exist

Any discussion of exchange rates and exchange-rate regimes should start with the question: Why do separate currencies exist? After all, from the point of view of pure economic theory, it might be best if the world had just one currency.

Money exists to facilitate trade among households, firms, and other institutions, and its common acceptability is what makes it useful. If there were just one currency, there would be no costly foreign-exchange trans-

actions to undertake, and international trade — not to mention borrowing and lending — would be that much cheaper to carry on.

At the same time, however, money's use in exchange and as the unit in which prices are stated and contracts drawn up gives it an inherently public aspect, making it a legitimate object of political concern.[2] And the institutions through which that concern finds expression tend to be national ones.

The first, purely economic, consideration mentioned above points to one currency for the whole world as desirable; but the second, political, one suggests that each nation will want its own. The international monetary system as it actually exists is the outcome of a compromise between these two forces.

A Canada-U.S. Monetary Union Is Not Politically Relevant

If national currencies tend to go along with nation states, it is not surprising that when nation states move toward political integration — as those of the European Community (EC) are now doing — the creation of a common currency, run by a supranational monetary authority, is soon on the agenda. If Canada were moving rapidly toward a similar form of integration with the United States, there would be a strong case for a monetary union, or — what would amount to the same thing — a Canadian-U.S. dollar exchange rate that was irrevocably fixed.

But Canada is not in this situation. The Canada-U.S. Free Trade Agreement — sometimes cited as a reason for moving to a fixed exchange rate — is only an agreement on *trade*. It is not even a common market arrangement, let alone the first step toward a more broadly based economic and political union.[3] That being the case, the Canadian and U.S. governments still retain responsibility for their own monetary systems, and their electorates will continue to hold them accountable for the way those responsibilities are exercised.

A Canadian-U.S. currency union would undoubtedly produce a North American monetary system that, from a narrow economic standpoint, would be cheaper to organize and maintain than current arrangements — particularly if it were accompanied by enhanced crossborder labor mobility. But such narrow economic advantages are not, and should not, be any more decisive here than in the choice of any other political arrangement. A merger of the two countries' federal governments into one would probably also save resources, but no one advocates it for that reason!

The Relevant Option: An Adjustable Peg

Political factors, then, dictate that — unlike the EC — neither a common North American currency nor an irrevocably fixed exchange rate can be on any serious policy agenda. If the U.S. and Canadian governments are to maintain their responsibilities for domestic monetary matters, then the only relevant choice of exchange-rate regimes involves the current flexible arrangement and a pegged exchange rate between the two currencies. If the latter is chosen, then the peg must be potentially adjustable — or even removable — in order to give the two governments scope to exercise their domestic political responsibilities.

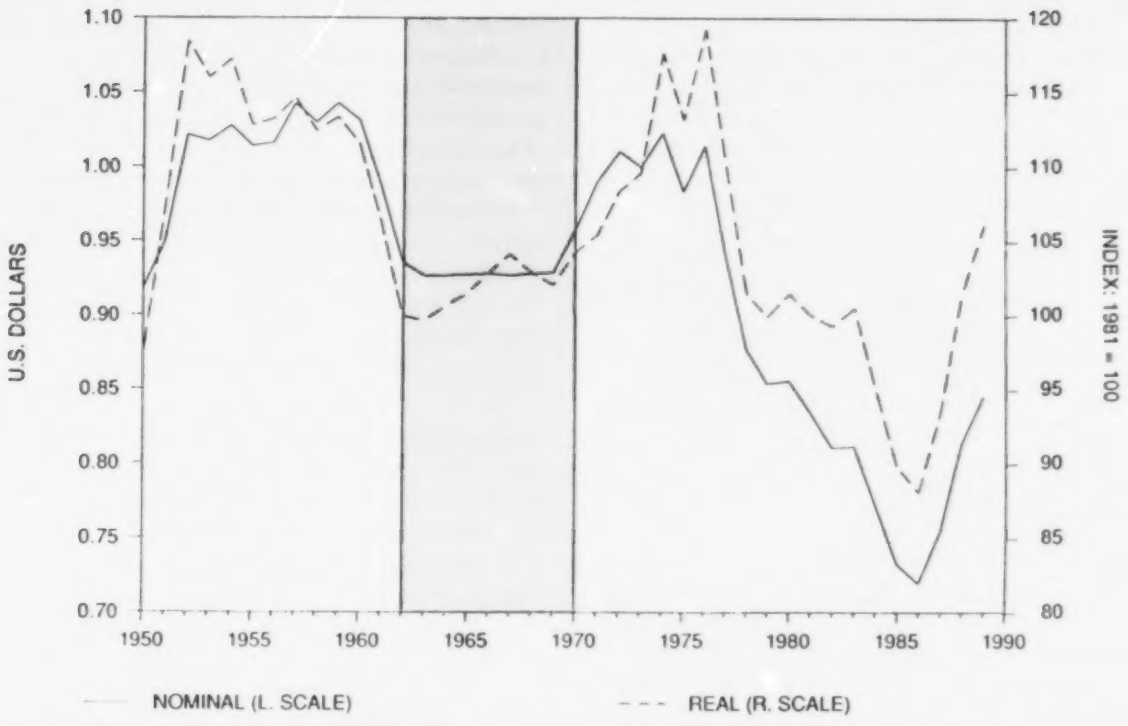
It is important to be clear about this, because some of the disadvantages of a flexible exchange rate — particularly those having to do with foreign-exchange-market speculation — which would be eliminated by the adoption of a common currency or an irrevocably fixed exchange rate, would still be at work under an adjustable peg system.[4]

Economic Fundamentals and Exchange-Rate Regimes

It is helpful to turn next to the question of how the values of various national currencies are affected by factors such as rates of inflation, and real shocks such as disturbances to trade and capital flows.

Figure 1

Canadian-U.S. Dollar Exchange Rate, 1950–89



Note: The shaded area indicates a period of a pegged Canadian-U.S. dollar exchange rate.

Sources: Bank of Canada; and C.D. Howe Institute calculations based on data from Statistics Canada and the U.S. Department of Commerce.

"Nominal" and "Real" Exchange Rates

Any analysis of exchange rates and exchange-rate regimes has to distinguish between "nominal" and "real" exchange-rate movements. The nominal Canadian dollar exchange rate against the U.S. dollar — represented by the solid line in Figure 1 — is the familiar rate quoted day-to-day: the number of U.S. dollars that one Canadian dollar can buy.

However, for many purposes — such as assessing changes in a country's international competitiveness — it is more useful to talk about the real exchange rate. Just as in phrases such as "real economic activity", the word "real" in this context denotes an adjustment for price-level variations. Under a flexible exchange-rate regime, other things being equal, the nominal exchange rate between two countries can be expected to move to offset the effects of differences in national rates of inflation. For instance, if, during a given period, Country A experiences a rate of inflation twice that of Country B, Country A's currency is likely, other factors aside, to lose half its value against Country B's over the same period.

It is possible to abstract from this influence by adjusting the nominal exchange rate for relative rates of inflation in the two countries. Thus, Canada's real exchange rate against that of the United States — shown by the dashed line in Figure 1 — is an index of the nominal exchange rate multiplied by the ratio of Canadian to U.S. prices, as measured by the two countries' price deflators for gross domes-

tic product. The real exchange rate shows how the relative competitive position of Canadian and U.S. producers has moved over time.

This adjustment reveals, for example, that the general downward trend of the Canadian dollar's nominal exchange rate against the U.S. dollar from the early 1970s to the mid-1980s was largely a result of worse inflation in Canada than in the United States. The fall in the real exchange rate was markedly less pronounced. Moreover, in the past three years, Canada's real exchange rate has risen back above its level of 1970–71, even though the nominal exchange rate remains significantly lower than it was in those years.

Real Shocks and Capital Movements

The fact that the nominal exchange rate adjusts to offset inflation differentials implies that if Canada and the United States were to achieve similar inflation rates, and if nothing else were to disturb the system, nominal exchange-rate stability between the two countries would almost certainly be achieved, even under a flexible exchange-rate regime. It also implies that if relative inflation rates were the only factors affecting the nominal exchange rate, the real exchange rate would remain constant during periods when the nominal exchange rate was free to float.

Figure 1 shows, however, that this has not been the case. Disturbances to the real exchange rate can arise from changes in underlying conditions of supply and demand for traded goods and services, or from changes in patterns of capital flows. These disturbances are a fact of life under fixed or floating exchange-rate regimes.

Resisting with Foreign-Exchange-Market Intervention

In order to understand the effects of such shocks under either regime, it is useful to picture a situation where world demand for Canadian goods increases, leading to an improvement in Canada's current account.

Under a flexible exchange-rate regime, the result would be a nominal — and, hence, a real — appreciation of the Canadian dollar. Under a pegged regime, however, nominal appreciation would be ruled out. To hold the dollar at its pegged level, one option for the Bank of Canada would be to buy up the additional foreign currency coming in through the current account with newly created dollars.

If the effect of these new dollars on the Canadian money supply is not matched by offsetting withdrawals — or "sterilized" — the additional money put into circulation will, over time, drive up Canadian prices and wages to the point where the initial improvement in the current account is eliminated. Exactly the same appreciation of the real exchange rate that will come about from a rise in the nominal value of the dollar under a flexible regime will arise instead from domestic wage and price increases under a fixed regime.

If the Bank does attempt to sterilize the effects of its foreign-exchange interventions on the money supply, the process is more complicated, but the results — though they may be delayed for a time — will eventually be the same. Sterilization involves the replacement of liquid assets in the monetary system by less liquid government debt securities. This will put upward pressure on domestic interest rates, which in turn will tend to generate a capital inflow. Thus, so long as the attempt at sterilization persists, not only will the upward pressure on the currency from the current account persist, but it will be exacerbated by pressure on the capital account. Such a policy is not sustainable. Eventually the money supply, domestic wages and prices — and, therefore, the real exchange rate — will move up.

Resisting with Easier Monetary Policy

A second, less direct way for the Bank to maintain a fixed nominal exchange rate in the face of an improving trade balance would be to switch explicitly to an easier monetary policy (instead of doing it in a roundabout way

Box 1

The Real Appreciation of the Canadian Dollar During the 1960s

The consequences of upward pressure on a pegged exchange rate from an improving current-account balance can be seen in Canada's own experience during the 1960s.

During the decade following the establishment of a pegged rate at 92.5 U.S. cents in 1962, a generally buoyant trade performance put upward pressure on Canada's real exchange rate. Since the nominal rate was fixed (and freedom to use foreign-exchange interventions was limited for most of the decade by an agreement with the United States setting a ceiling on Canada's foreign-exchange reserves) resistance to this pressure took the form of a monetary policy that was, on average, somewhat easier than that followed south of the border.

As a result, Canadian inflation ran a little ahead of U.S. inflation for most of the decade, and the real exchange rate followed a generally appreciating trend, as is illustrated in Figure 1, even though the nominal rate remained unchanged.

through the foreign-exchange interventions just described) by supplying additional liquidity to the financial system. This easier monetary stance would tend to lower Canadian interest rates relative to U.S. rates, producing counteracting downward pressure on the dollar *via* the capital account. But it would also boost the money supply, and eventually drive up wages, prices — and, therefore, the real exchange rate — just as before (see Box 1).

Capital-Account Disturbances

Balance-of-payments disturbances can also arise from variations in capital flows. Though the source of the disturbances is different, their effects on the real exchange rate are identical to those just described. An increase in inflows of capital will, under a flexible regime, drive up the nominal — and thereby the real — exchange rate. When the nominal rate is pegged, on the other hand, it will lead to domestic wage and price increases that will drive up the real exchange rate. And in this case also, efforts to maintain the pegged rate by sterilized foreign-exchange operations may delay the result, but cannot prevent it.

Moral: The Consequences of Real Shocks Are Inescapable

These particular examples illustrate a more general fact. Any nonmonetary shock — whether in the trade account or the capital account — that requires an appreciation of the real exchange rate will lead to a nominal exchange-rate appreciation under a flexible regime and will put upward pressure on domestic wages and prices under a fixed regime. Correspondingly, any nonmonetary shock that requires a depreciation of the real exchange rate will lead to a nominal depreciation under a flexible rate and to domestic deflation under a pegged rate. Although the nature of the exchange-rate regime changes the short-run mechanics of the adjustment, it cannot alter the long-run real consequences.

A Point in Favor of a Flexible Exchange Rate

The fact that real shocks will make themselves felt regardless of the exchange-rate regime does not in and of itself establish a case in favor of a flexible exchange rate. But it is important to note that the nominal exchange rate moves much more flexibly than do domestic wages and output prices.

Adjustment to real shocks requiring a change in the real exchange rate is therefore likely to be quicker (and more easily reversed if necessary) under a flexible regime, when the nominal exchange rate can move to bring it about. Under a pegged regime, hard-to-make changes in wages and prices are required. To the extent that such shocks are likely to be an important source of disturbance to Canadian-

U.S. transactions in the foreseeable future, then, a flexible exchange rate between the two economies is desirable.

Why Peg?

It is now time to turn to the arguments made by proponents of a pegged exchange rate, and to ask whether their perceptions of the benefits of pegging are accurate.

Will Pegging Insulate the Economy from Sectoral Shocks?

Shocks to trade flows of the sort discussed earlier tend to arise in particular sectors of the economy, and it is sometimes argued that a flexible nominal exchange rate causes the effects of these shocks to impinge upon the economy as a whole in a way that would not occur under a fixed rate. This is not so. Wherever the shocks arise, the resulting adjustment of the real exchange rate will have the same long-run effects on the rest of the economy, regardless of the regime governing the nominal exchange rate.

Under the current flexible exchange-rate regime, the consequence of an increase in U.S. demand for goods produced in one industry — say, forest products — is a nominal appreciation of the Canadian dollar and an associated rise in the real exchange rate. This puts pressure on other sectors of the economy subject to foreign competition, such as manufacturing. But there is no reason to believe that if the nominal exchange rate were pegged, the consequences would be confined to the forestry sector alone.

The economy-wide effects of a real exchange-rate change — whether brought about by an appreciating nominal exchange rate or by a general rise in wages and prices — are part of the means whereby markets signal a need for a reallocation of resources between sectors. One cannot short-circuit this signal by tinkering with the monetary system; nor should one wish to.

To return to our example, if the forestry industry is to meet the new greater demand for its output, it will need to draw resources from somewhere else in the economy, including perhaps the manufacturing sector. Under a pegged regime, the appreciation of the real exchange rate associated with rising domestic wages and prices will put contractionary pressure on other sectors similar to that caused by a nominal appreciation under a flexible regime. The difference is that, under the fixed exchange rate, the manufacturer experiences this pressure in the form of rising costs of labor, materials, and equipment relative to unchanged output prices. Under a flexible rate, the pressure takes the form of unchanged input costs, but output prices that are under downward pressure because of a higher nominal value of the Canadian dollar.

Now, if Canada and the United States shared a common labor market, with no hindrance to crossborder movements, matters would be different. Sectors in Canada that had to expand and attract more labor would be able to seek it south of the border, and a fixed exchange rate might help to transmit the appropriate wage and price signals. That, however, is a completely different story — and under current arrangements, which heavily restrict crossborder labor mobility, an irrelevant one too.[5] What is at issue here is exchange-rate arrangements between individual nation states, not monetary aspects of a broader program of economic and political integration like that of the EC.

Will Pegging Stop Tight Money from Pinching the Tradeables Sector?

Advocates of a fixed exchange rate sometimes claim that, under a flexible exchange-rate regime, the burden of anti-inflationary monetary policy is unfairly concentrated on producers of tradeable manufactured goods and primary products, as opposed to firms involved with nontradeables — particularly services. This argument has received a great deal of attention lately because of the influence of the Bank of

Canada's anti-inflation policy. We have no doubt that the current strength of the Canadian dollar owes much to the fact that, after being quite loose in late 1986 and early 1987, monetary policy began to tighten up in late 1987 and became noticeably restrictive in early 1989.

Since monetary policy began to tighten, the Canadian dollar has appreciated sharply, while domestic prices have been responding with their usual two-year-plus lag to the previous inflationary monetary stance. This combination of a rising nominal exchange rate and domestic inflation higher than that in the United States has involved a marked rise in the real exchange rate, creating significant problems for producers of tradeable goods and services.

As noted earlier, the nominal exchange rate is a more flexible price than are domestic wages and goods prices. Although this property gives a flexible exchange-rate regime an advantage in coping with real shocks, it puts it at a disadvantage when the shocks are monetary. When monetary policy is tightened, for example, the nominal exchange rate moves up in advance of the deceleration of wages and prices, producing a temporary appreciation of the real exchange rate and hardship for sectors of the economy that are particularly exposed to exchange-rate movements.[6]

But the significance of this fact should not be overstated. The burden of adjustment to tighter money is not borne solely by producers of tradeable manufactures and primary products. Other sectors, too, are affected, some of them just as severely. Tight monetary policy raises interest rates as well as the exchange rate, and producers of any nontradeable good whose demand is particularly interest-sensitive are also directly and obviously affected — ask any house builder. Furthermore, the appreciating exchange rate makes business and vacation travel in the United States cheaper, putting pressure on domestic suppliers of substitutes — ask any hotelier or retailer who relies on tourist or convention trade.

In the final analysis, adopting a different exchange-rate regime is not the way to avoid the costs of disinflating. Adjustment to a lower inflation rate would be painful under a fixed exchange rate too, although the pain might be allocated differently.

The real remedy is to avoid instability in monetary policy in the first place. Unlike the real shocks discussed earlier, monetary shocks are policy-induced, and can be avoided. The current high value for the Canadian dollar has its roots in the inflationary stance of monetary policy some three years ago. It is a consequence of erratic monetary policy, not of a flexible exchange rate.

Will Pegging Help Canada Get Inflation Down to U.S. Rates?

One argument for pegging the Canadian dollar to the U.S. dollar begins with the position that inflation imposes important costs on the economy and on society as a whole. Since the United States has, for the past two decades, generally run a lower inflation rate than has Canada, it is tempting to argue that Canada could "import" the U.S. tendency to lower rates of inflation by pegging the exchange rate.[7] But it is doubtful that the matter is that simple.

Setting aside the problem of selecting the "right" value at which to fix the exchange rate, and assuming that an appropriate choice had been made, the first task facing the Bank of Canada would be to establish the peg's credibility. That would inevitably entail taking steps to bring Canadian inflation rate down to the U.S. level — by persevering, in fact, with the Bank's current goal of establishing price stability, because the U.S. Federal Reserve currently seems to be pursuing that goal, too.

If such steps were not taken, the peg would not be sustainable over time, would not be credible, and would be attacked by speculators. A pegged exchange rate would not, then, be a substitute for tight monetary policy in achieving a lower inflation rate in Canada. Rather, it would be a self-imposed restraint, which might even, depending on the Federal

Box 2

Interest Rates and Inflation under a Pegged Regime

Canada's experience with a pegged exchange rate during the 1960s does not support the idea that a peg allows instant "importing" of either lower inflation or lower interest rates.

The problems with pegging at too low a value are illustrated by Canada's experience immediately following the adoption of the 92.5 U.S. cents peg in 1962. In the face of this substantial devaluation — the new value was some 10 percent below the average level of the preceding five years — investors at first lacked faith that the government would defend even this lower rate. As a result, the new peg had to be defended with a dramatic tightening of monetary policy.

As already noted, once that episode was over, resistance to the upward pressure of a generally buoyant trade performance on the pegged rate took the form of a monetary policy that was relatively loose. As a result, inflation in Canada was worse than that in the United States in the early 1960s. This led, in turn, to a shift once again to a more restrictive stance — and a widening of Canada-U.S. interest rate spreads — in mid-decade.

Interestingly, the spread between Canadian and U.S. interest rates — both short- and long-term — was, on average, wider during the period of a pegged exchange rate in the 1960s than during the floating period of the 1950s.

Reserve's vigor in pursuing price stability, force the Bank into an even more stringent monetary policy than that now in place.

Will Pegging Eliminate the Canada-U.S. Interest-Rate Premium?

The case for pegging the Canadian dollar has also been made on the grounds that current premiums of Canadian over U.S. interest rates — roughly 5 percent at the short end and 2 percent at the long end — reflect a relative lack of credibility of monetary policy in Canada. By pegging the exchange rate, it is argued, Canada would be able "import" credibility from the United States, eliminating this premium.

This argument is, in fact, a variation on the previous one about inflation. Its validity hinges on the same factor: the credibility of the peg. Unless the simple announcement of a pegged exchange rate made the Bank's anti-inflation stance more believable than it is now, the peg would do nothing to reduce Canadian interest rates. Indeed, if the peg's credibility had to be reinforced by visible action on the part of the Bank, it is conceivable that short-term interest rates would have to remain high, or even rise, in the wake of its adoption.

Nor can this problem necessarily be avoided by adopting a low and therefore easily sustainable value for the exchange rate. Pegging at an inappropriately low rate will generate immediate upward pressure on prices that will hinder the achievement of an inflation rate similar to that of the United States in the near term. And in the longer term, defending an artificially low rate against upward pressure from the current and capital accounts might undermine efforts to control inflation, if that defense began to generate suspicions that the Bank of Canada had permanently abandoned its zero-inflation goal (see Box 2).

Will Pegging Discipline Canadian Monetary Policy?

Both of the foregoing arguments are really special cases of a position often advanced by advocates of fixed exchange rates — namely, that the obligation to maintain a pegged rate imposes discipline on governments, inhibiting them from opting for unstable inflationary domestic policies.

The obligation to maintain an exchange rate pegged to a low-inflation currency would certainly prevent a government from indulging in domestic inflation. But a government intent on pursuing inflationary policies for other reasons is not likely to find this obligation very compelling, and would be unlikely to adopt a

Box 3

Monetary Policy Discipline with Pegged Exchange Rates

History appears at first sight to lend support to the view that pegged exchange rates promote disciplined monetary policy. In the late 19th century, when most countries maintained a fixed price for gold — the then-ruling international money — they were, by modern standards, relatively free of inflation. And the period from the end of the Korean War until the mid-1960s, when the U.S. dollar replaced gold as the key currency under the postwar Bretton Woods system, was one of worldwide monetary stability.

Further thought points to a problem with this simple interpretation of the past, however. For a pegged exchange rate to impose discipline on monetary authorities, the peg must be against the currency of a country whose own policymakers are disciplined. The stability of the gold standard derived from the disciplined conduct of monetary policy in the country that lay at its center — namely, the United Kingdom. That discipline evaporated with the onset of World War I. U.S. policymakers were disciplined in the early part of the Bretton Woods period, but from the mid-1960s onwards, under financial pressures generated by the Vietnam War, they became less so.

When the Bretton Woods system collapsed, it was because countries like West Germany found it impossible to maintain both anti-inflation discipline and a fixed exchange rate against the U.S. dollar. It was not because countries other than the United States were eager to indulge in inflation and found the fixed exchange rates of the Bretton Woods system a hindrance.

All this suggests that, in monetary matters, discipline begins at home, rather than being imposed by the exchange-rate regime. Since World War II, Canada has enjoyed both its best decade of monetary stability (from 1952 to 1962) while operating a flexible exchange rate, as well as its worst (from 1973 to 1983).

pegged rate in the first place, or stick with it if it was adopted. Only a government that wished to avoid inflationary policies in the first place would be willing to accept such discipline.

To return to a point made at the outset: in the world we live in, for good or ill, monetary policy is the responsibility of national governments. It is, therefore, to domestic political processes, not to international monetary arrangements, that we must look for the incentives to ensure that this responsibility is competently discharged (see Box 3). The degree to which a government is disciplined by domestic political considerations will affect its policy choices, including those associated with the exchange-rate regime, and policy choices that are inconsistent with a government's degree of discipline will not be made.

In summary, a government that would benefit from a fixed exchange rate will not choose it, and a government that would choose such a regime will not benefit from it. The argument that the choice of a pegged exchange rate will impose discipline on domestic policy puts the cart before the horse.

Will Pegging Eliminate Foreign-Exchange Speculation?

Credibility Again

Some of the discomfort that politicians and business people now voice about Canada's flexible exchange-rate regime arises from short-term volatility in the rate associated with the activities of currency speculators. Under a flexible exchange-rate regime, speculators tend to move in anticipation of events. If they decide to buy Canadian dollars in advance of some change that would, in the ordinary course of events, cause the dollar to appreciate, then that very act tends to bring the appreciation forward in time, and sometimes to exaggerate its size, too. (The same is true of their actions in anticipation of a depreciation.)

There is no doubt that the problems to which such speculative activity can sometimes lead would be eliminated by a credibly fixed exchange rate. However, the qualifying adjective "credibly" is all-important here. If Canada were to adopt the U.S. dollar as its domestic

currency, or to commit itself irrevocably to a particular U.S. dollar exchange rate, then Canadian-U.S. dealings would be immune to the activities of speculators.

But, to repeat, these arrangements are not politically feasible. It is fundamental to a pegged-rate arrangement that central banks — if they are to remain answerable to the domestic electorate for their conduct — have to maintain the ability to adjust or even remove the peg. And a peg that is adjustable can never be totally credible. So even with an exchange rate pegged to the U.S. dollar, the Canadian dollar would be of interest to speculators whose activities could create difficulties both for the Bank of Canada in particular and the economy in general.

Speculation under Pegged and Flexible Rates

Any event that would, under a flexible exchange rate, lead to an appreciation of the Canadian dollar would, under a pegged rate, lead to an increase in the chance of the peg's being adjusted upward. This prospect would generate a speculative inflow of short-term funds, carrying with it a danger of faster monetary expansion and inflation. And attempts to sterilize the expansion of the domestic money supply would only prolong and exacerbate the problem. Conversely, any increase in the probability of an exchange depreciation might provoke a speculative attack on the currency, which in turn would make such a depreciation more likely.

In short, the same type of speculative activity that, under a flexible regime, makes the exchange rate tend to fluctuate too much for comfort would, under a fixed rate, make the peg harder to sustain. And in the face of large shocks, where a flexible exchange rate would move a lot, speculators are offered something that begins to approach a one-way bet. Under these circumstances, the resources of a central bank might well be overwhelmed by the weight of speculation, and a change in the peg in the direction anticipated by the speculators becomes a near certainty.

As a matter of reality, then, large shocks under either a formally flexible or a pegged regime are likely to lead to nominal exchange rate movements. Under a pegged rate, though, the movements in question are likely to be delayed, and to take place in crisis conditions (see Box 4).

Two Key Questions: Where and When?

Before attempting to summarize the implications of this discussion for Canada's current circumstances and policy options, two further issues remain to be dealt with: a serious advocate of a pegged exchange rate must be willing to state both the value of the peg and the time at which it should be established.

Where to Peg: What Is the Appropriate Value for the Dollar?

It is generally acknowledged that the Canadian dollar is currently above a nominal value *vis-à-vis* the U.S. dollar that would be justified on the basis of, say, domestic purchasing power. The recent strength of the real exchange rate, as shown in Figure 1, suggests this very strongly. But it is one thing to acknowledge this and quite another to put an exact figure on the difference.

How excessive has the Canadian dollar's appreciation been over the past year? How long will it be before it moves to an "appropriate" level against the U.S. dollar? And what will that "appropriate" level be when the time comes? The defender of a flexible exchange rate does not have to answer these questions: the market will deal with all of them in due course. But the advocate of a pegged rate must take a view about them. One cannot argue for instituting a pegged rate without suggesting a value for the peg.

If the chosen value is too high, domestic wages and prices will have to be adjusted to

Box 4

Speculative Crises and Pegged Rates

The crisis conditions that surround — and the abrupt nominal exchange rate moves that follow — the abandonment of a pegged rate are evident in Canada's experiences of 1950 and 1970.

In 1949 and 1950, Canada's long-term capital-account balance showed a marked improvement, as reconstruction loans to Europe wound down and U.S. direct investment in Canada picked up. This improvement was reflected in upward pressure on the Canadian dollar — then pegged at 90.9 U.S. cents — which was resisted with foreign-exchange intervention.

When the improving long-term balance was augmented by large inflows of short-term speculative funds, prompted by the growing prospect of a revaluation, the pressure became too much to resist. By the end of September 1950, Canada's foreign-exchange reserves had ballooned by almost one-half from their level of three months earlier, and — amid fears that the already severe inflation of the period would be exacerbated by continued interventions — the dollar was floated. During the next two months, it rose by as much as 6.5 percent above its pegged level.

The decision to float in 1970, on the other hand, followed a period of upward pressure on the dollar arising from an improvement in the current account. This occurred at a time when the entire Bretton Woods system of fixed exchange rates was looking increasingly shaky. Short-term funds were therefore all the quicker to respond to an anticipated revaluation.

After heavy foreign-exchange interventions during the first five months of 1970, which again threatened to boost inflation, the decision was made to abandon the 92.5 U.S. cents rate set in 1962. The dollar was floated at the end of May, and rose sharply, nearly reaching par with the U.S. dollar during September (an appreciation of 7.8 percent in less than four months).*

*An account of the events of these periods can be found in A.F.W. Plumptre, *Three Decades of Decision* (Toronto: McClelland and Stewart, 1977), pp. 142–145, 220–221.

bring them into line with those in the United States. In the current Canadian context, that would imply a disinflationary burden over and above that already involved in trying to achieve domestic price stability. Indeed, if the United States is itself moving toward price stability, Canada might face a period of actual *deflation* — falling prices — in order to achieve a price level compatible with maintaining a high peg.

If the rate is pegged too low, then a short-term bout of inflation will be needed — hardly a desirable occurrence at a time when the credibility of monetary policy requires visible evidence of progress against inflation. These problems can be avoided if the "right" value for the exchange rate can be found — but no one can say with certainty what that value is.[8]

When to Peg: Is This a Good Time?

Nor is it possible to argue for a peg without specifying when it ought to be put in place. The current period, when the economy is in transition from a higher to a lower inflation rate, seems a particularly bad time for pegging the exchange rate, because the dynamics of the transition make it particularly difficult to judge just what the right exchange rate for the longer term might be. If Canada is to adopt a pegged rate against the U.S dollar, the time to do that is after — not before — the two economies have achieved desirable and compatible long-run inflation targets.

Moreover, other considerations suggest that, even in the presence of congruent, low Canadian and U.S. inflation rates, a pegged rate might not be desirable in the near future.

To begin with, adjustments to the Free Trade Agreement are by no means finished. No one can be sure what their future effects on trade patterns — or, more immediately important, on capital flows — are likely to be. Add to this the fact that some kind of United States-Mexico agreement seems to be on the medium-term horizon. Such an arrangement is bound

to impinge upon the pattern of Canada-U.S. trade and capital movements, but how, where, when, and to what extent is anyone's guess.

Beyond these considerations lies Canada's apparently chronic state of constitutional uncertainty. Regardless of what happens during the remainder of this summer, it is all too likely that Canadian confederation is going to be subject to all manner of stresses and strains in the next few years. These, in turn, are likely to exacerbate an already difficult political problem of fiscal deficit control.

An honest assessment of the implications of all these considerations for the Canadian-U.S. exchange rate in the coming years has to acknowledge a great deal of uncertainty. The burden of setting out a coherent and complete accounting of their impacts lies heavily on anyone advocating a pegged rate who wishes to be taken seriously.

Concluding Comment

In our view, the sources of uncertainty now surrounding the Canadian-U.S. exchange rate are several: suspicions on the part of market participants about the capacity of the monetary authorities in the United States and Canada to follow through on their good intentions *vis-à-vis* inflation; the difficulties of foreseeing the patterns of trade and capital flows required by adjustment to actual Canada-U.S. and potential U.S.-Mexico free trade arrangements; political uncertainties associated with Canada's current constitutional impasse; and suspicions about the viability of current fiscal regimes.

Though a stable economic environment in general — and a stable Canadian-U.S. exchange rate in particular — are undoubtedly desirable, they are not going to transpire until these underlying problems are solved, regardless of the formal nature of the exchange-rate regime. To suggest that they can be fixed by tampering with monetary arrangements is simply to distract attention and energy from the search for real solutions to them.

Canadians would do well to devote their energies to the latter task and, in the meantime, let the exchange rate look after itself. Attempting to introduce and then defend a particular value for the Canadian dollar against the U.S. dollar in current circumstances would simply complicate further an already challenging situation, to no constructive purpose.

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Quotation with appropriate credit is permissible.

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Notes

1 See, for example, Robert Mundell, "The Overvalued Canadian Dollar" (paper prepared for the Canadian Monetary Policy Review Board, Montreal, April 4–5, 1990); Thomas J. Courchene, "Zero Means Almost Nothing: Towards a Preferable Inflation and Macro Stance" (background paper prepared for the House of Commons Standing Committee on Finance, Ottawa, June 7, 1990); and Pierre Fortin, "Can the Costs of An Anti-Inflation Policy Be Reduced?" in *Taking Aim: The Debate on Zero Inflation*, edited by Robert C. York (Toronto: C.D. Howe Institute, forthcoming). Though each of these authors advances some of the arguments discussed below, none advances all of them. This *Commentary*, therefore, should be read as a general critique of the practicalities of adopting a fixed exchange rate, rather than an evaluation of any one specific proposal.

2 It is very widely accepted — though not quite universally so — among economists that the monetary system will not quite manage itself. See, however, F.A. von Hayek, *Denationalising Money* (London: Institute of Economic Affairs, 1976), for a fascinating discussion of the case for letting market mechanisms govern the monetary system.

3 A common market, as opposed to a free trade area, typically involves a common external tariff and free movement of labor among its members. Unlike the EC, the Canada-U.S. arrangement provides for neither of these.

4 Much of Robert Mundell's case for fixing the Canadian exchange rate seems to rest on a presumption that it could be fixed irrevocably. The differences between the analysis in this *Commentary* and his views therefore rest more on a difference of judgment about what is politically feasible than on a fundamental difference of opinion about economic analysis.

5 In discussing the case for a fixed exchange rate, neither Mundell nor Courchene seems to pay sufficient attention to labor mobility questions — and particularly to the fact that labor is able to move rather freely between regions of Canada but not between the United States and Canada.

6 The tendency of a flexible exchange rate temporarily to overshoot a long-run sustainable value in the face of monetary policy changes is analyzed by Rudiger Dornbusch, "Expectation and Exchange Rate Dynamics," *Journal of Political Economy* 84 (December 1976).

7 Not all proponents of a peg take this view. Mundell does not take zero inflation seriously as a U.S. policy goal. He believes, for unspecified reasons, that U.S. inflation will remain in the 4–6 percent range (p. 19). Fortin raises the point, however.

8 Mundell (p. 31) cites a recent estimate by John McCallum of McGill University that suggests that an exchange rate of about 78 U.S. cents would be justified by purchasing-power-parity considerations. While there is no reason to quarrel with this particular estimate, it is one thing to produce such a number as an academic exercise, and something else altogether to use it as the basis of a major policy initiative. Mundell gives no indication of the margin of error that it might be appropriate to apply to such an estimate, nor does he discuss the consequences of its being in error. Fortin cites an estimate (John Williamson, "A FEER for the Canadian Dollar," appendix to Paul Wonnacott, *The United States and Canada: The Quest for Free Trade* [Washington, D.C.: Institute for International Economics, 1987]) of a "fundamental bilateral equilibrium Canadian-U.S. exchange rate" of 74 U.S. cents. Courchene (pp. 22–24) argues for a peg at 80 U.S. cents.

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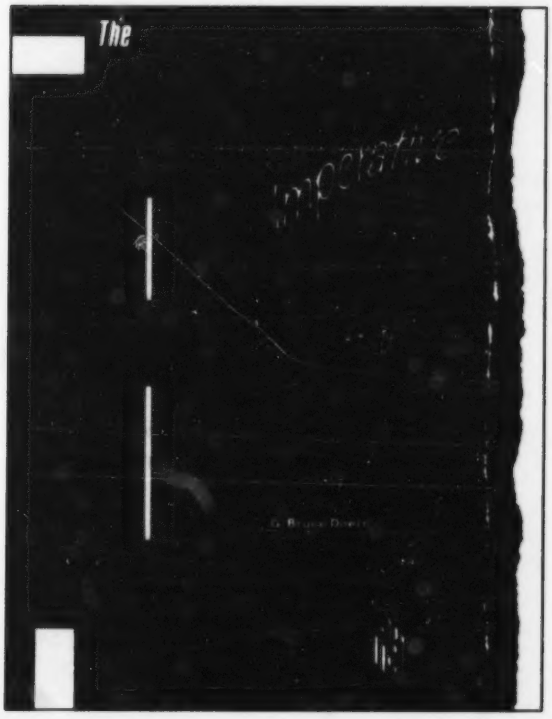

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